access reform to "drive access rates to economically efficient levels"[85], and supports the use of TSLRIC-based rate levels.[86]

With those goals in mind, the Commission must determine the best method for moving rates from those produced by the historic, embedded cost standard appropriate for noncompetitive marketplaces to those resulting from efficient forward-looking economic costs, which allow a competitive market to evolve. In the present drive to establish a competitive marketplace for access services (which Ad Hoc fully supports), the Commission cannot abandon the primary goal of economic regulation - to ensure that the prices charged by regulated firms operating in noncompetitive markets emulate the prices that would be charged in a competitive marketplace. Having established that the existing prices set by the existing access charge system do not reflect the prices that would exist in a competitive market, the Commission must first correct that problem through prescriptive reform of not only the access charge rate *structures* but the rate *levels* as well.

In the *Notice* at paragraphs 223-238 (and at paragraphs. 247 to 270, discussed in Section C.3.e., below), the Commission proposes a number of

---

85 *NPRM* at ¶220

86 At paragraph 222, the *Notice* states "in the event we determine that a market-based approach will not result in the development of efficient competition, we tentatively conclude that our goal for prescriptive access reform should focus on interstate access rates based on some form of a TSLRIC pricing method." As evidenced by our discussion above, the Ad Hoc Committee supports use of prescriptive pricing as a transition to the development of an efficiently competitive marketplace rather than as a replacement for same.

potential mechanisms designed to address the *overall rate level* problems inherent in the existing access charge plan. Foremost among the solutions being contemplated is re-initialization of PCIs, but the Commission questions whether this "administratively easy" fix should be adopted in light of the fact that re-initialization alone will not necessarily result in individual prices being driven to economically efficient levels.[87]

The Committee believes that the PCI must be reinitialized so that aggregate revenues allowed under price caps equate with the aggregation of revenues from individual services priced at TSLRIC. By tackling the *rate structure* modifications proposed in Section III. of the NPRM in tandem with this re-initialization, the Commission retains the ability to target the majority of the resulting reductions to those prices that are most economically inefficient at this time.[88] By quantifying the impact of the proposed rate structure changes, *e.g.*, the elimination of the Transport Interconnection Charge, and first targeting any PCI reductions to implement those proposed changes, any overall re-initialization of the PCI that would be required to make up the difference would likely be small.

---

[87] The Commission's concerns relative to trade-offs between administrative simplicity and precision in targeting rate level reductions remains regardless of the basis for any PCI re-initialization (e.g., increased CPD or reset rate of return).

[88] In fact, absent a "prescriptive" change in the overall rate levels, it will be all but impossible for the Commission to effect many of the major rate structure changes it contemplates in an "economically efficient" manner. For example, a decision to address the rate structure problems identified in the Notice relative to the CCLC (¶¶ 57-67) and the TIC (¶¶ 96-122), if pursued separate and apart from re-initialization of rates at TSLRIC levels, is likely to result in large revenue shortfalls that need to be made up from other services. The temporary transfer of

The Commission can easily re-initialize the rates of the price caps carriers subject to the instant docket while simultaneously correcting the most glaring of the rate structure problems inherent in the present access charge plan. Indeed, reinitializing to an 11.25% rate of return (or some newly-determined rate of return level) reinforces the intended mirroring of competitive market efficiencies that the price cap plan is designed to provide. In competitive markets, supra-normal returns are only maintained for a finite period of time before competitors cause overall price levels to ratchet down. A reset of the access charge price levels to the authorized rate of return emulates the kind of pricing activity that would be expected in a competitive industry by the introduction of a new, efficient provider into a market that is presently allowing existing providers to earn supra-normal returns. The benefits of economically efficient pricing (both to ratepayers and to the development of competition) *far* outweigh any negative effects that re-initialization might have in terms of "dampening" the efficiency incentives of the price caps plan.

The Commission could also easily re-initialize the rates of the price caps carriers subject to the instant docket to an 11.25% rate of return (or some newly-determined rate of return level), thereby reinforcing the intended mirroring of competitive market efficiencies that the price cap plan is designed to provide. In competitive markets, supra-normal returns are

---

revenue responsibility for costs that should not be recovered at all from one rate element to

only maintained for a finite period of time before competitors cause overall price levels to ratchet down. A reset of the access charge price levels to the authorized rate of return emulates the kind of pricing activity that would be expected in a competitive industry by the introduction of a new, efficient provider into a market that is presently allowing existing providers to earn supra-normal returns. The benefits of economically efficient pricing (both to ratepayers and to the development of competition) *far* outweigh any negative effects that re-initialization might have in terms of "dampening" the efficiency incentives of the price caps plan.

The Commission also questions the relationship between TSLRIC-based pricing for access services, and TELRIC-based prices for UNEs, and whether the TELRIC UNE prices for some elements could be substituted for access service.[89] Ad Hoc has been unable to identify reasons why the TELRIC results for UNEs should vary substantially from properly-specified TSLRIC results for access services since, in most cases, the access "services" in question mirror the UNE "elements." As an example, the SLC and CCLC components of the present access charge plan represent the interstate assignment of the very same "loop" that is priced out as a UNE. In determining the appropriate forward-looking SLC and CCLC rate levels, the Commission should use the forward-looking TELRIC-based UNE for

---

another is not economically efficient.

[89] *NPRM* at ¶¶ 220-222.

loops. Likewise, Ad Hoc is could not identify any reason why the forward-looking cost result for interstate access Transport and Switching would be any different than the UNE results for those elements.[90]

C. Parameters of a market-based approach (¶¶ 161-217)

As explained in the section above, Ad Hoc believes that a well-specified prescriptive approach is a more efficient means of accomplishing the Commission's competitive pricing objectives, pending the development of competition, than the market-based approach described in paragraphs 161 to 217 of the *Notice.* When effective competition has become established in any market segment, the Commission can just as easily make a transition to a market-based framework from a prescriptive approach than from the Phase I market-based framework described in the *Notice.*

Under Phase I of its market-based approach, the Commission proposes broad pricing flexibility for ILECs when they demonstrate *potential* competition for access services in specific geographic areas. In particular, the Commission proposes to lift regulatory constraints, to allow geographic de-averaging within a study area, to authorize ILECs to offer volume and

---

[90] While the common costs associated with "services" may be higher than for some "elements" (because the "services" are comprised of multiple "elements"), there is no reason why the common cost assignment for a "service" that is comprised of a single "element" should be higher than for the element (see discussion in *NPRM* at ¶ 221). Although the Commission speculated at ¶ 221 that billing and marketing expenses might differ between UNE's and access elements because access elements are available to end users, the overwhelming majority of such

term discounts for access services, contract tariffs and individual requests for proposal (RFP) responses. The Commission also proposes to lift certain restraints on the ILEC's ability to offer new access services. The NPRM lists eight conditions and asks whether "*some or all*" should apply before the Phase I deregulation occurs. The Commission gives particular emphasis to pricing conditions for ILEC-provided local exchange services relied upon by potential competitors, including the availability of unbundled elements at geographically de-averaged TELRIC prices, along with cost-based rates for local transport and termination services and wholesale prices for retail services that conform with the standards of Sections 251 and 252 of the Telecommunications Act.

Deregulation, either in the form of Phase I pricing flexibility or the substantial relaxation of price cap regulation under the proposed Phase II, must be linked to clear evidence of competitive conditions in relevant markets. As the Commission has previously recognized, the Price Cap Docket's *Second Further Notice of Proposed Rulemaking* ("*Price Cap Second FNPRM*"),[91] which is re-noticed in the present proceeding, a necessary precondition to evaluating the competitiveness of markets is to

---

services are purchased by carriers. Thus, the costs of billing and marketing to end users should be *de minimus*.

[91] Second Further Notice of Proposed Rulemaking in CC Dkt. No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Dkt. No. 93-197, 11 FCC Rcd 858 (1995) ("*Price Cap Second FNPRM*").

properly define "the relevant market."[92] In the *Second FNPRM*, the Commission focused upon two types of definitions for a relevant market — the relevant product market and relevant geographic market. Specifically, in the *Price Cap Second FNPRM*, the Commission's focus indicated that it was seeking a model for defining product and geographic markets in access service that can serve as the "base units for evaluating competition in the access markets."[93]

Ad Hoc strongly supports the concept that the relevant market must be defined both functionally and geographically. Before any form of market-based deregulation is considered, two threshold conditions must apply:

1. There must be competition throughout the entire market segment (defined both functionally and geographically); and

2. The relevant (competitive) product or geographic market must not have substantial joint and common costs with another product or geographic market that is not competitive.

1. Functional markets

A functional market definition must encompass both inter- and intrastate services. In proposing to require that the conditions for local exchange competition be in place within a geographic area before it will consider allowing pricing flexibility for access services, the Commission appears to have recognized that economic markets are not constrained by

---

92 *Price Cap Second FNPRM* at ¶ 116.

93 *Id.* at ¶. 116.

jurisdictional boundaries or arbitrary regulatory classifications. Regardless of whether the Commission is permitted to play a prominent role in establishing the conditions for competition in the local exchange market or is confined to setting structural rules, it must consider both inter- and intrastate services in defining any relevant product market.[94]

The Commission's authority to set pricing rules and proxies for the elements and services necessary for the provision of competitive local exchange services has been challenged and the challenge is as yet unresolved.[95] Whether or not the Commission is deemed to have

---

[94] In its Comments on the *Price Cap Second FNPRM*, Time Warner posits an example in which an interstate service (switched transport) that is characterized by high demand elasticity and high supply elasticity is provided over the same facilities as an intrastate service (intrastate message toll service), which is not yet competitive. Comments of Time Warner on Price Cap Second FNPRM at 41. Regarding this example, Time Warner notes that "the LEC would have a unique and formidable advantage over any other facilities-based provider by virtue of its ability to share and to shift costs for the interstate switched transport with and to the intrastate toll market." In this example, looking exclusively at the interstate service would lead to an erroneous conclusion regarding the existence of effective competition in this market.

[95] Iowa Utilities Board, *et al. v. FCC,* No. 96-3321 *and consolidated cases* (8th Cir. Oct. 15, 1996) ("Interconnection Appeal"). Ad Hoc supports the Commission's continuing commitment and efforts to uphold its jurisdiction to set national pricing standards for unbundled network elements and wholesale services, and considers it imperative that the Commission reinforce its commitment to economic pricing of access charges. However, the Ad Hoc Committee is concerned with the implications of linking access reform to pricing conditions for local exchange services over which the Commission's authority is presently clouded. At paragraph 170 of the NPRM, the Commission states its expectation that "availability of unbundled elements at TELRIC prices as a substitute for access charges will ultimately require the LEC to set its charges in an economically efficient manner." Unfortunately, at this critical juncture, when the Commission has committed itself to rationalizing access charges and the prices for unbundled elements, the stay of the Commission's *Interconnection Order* by the Eighth Circuit Court of Appeals creates uncertainties as to whether the Commission will actually be able to enforce TELRIC pricing standards and keep them reasonably consistent across the nation. Should individual states be free to deviate significantly from the TELRIC benchmarks established by the Commission or to adopt an entirely different costing basis, a major piece of the framework upon which the Commission has premised the market-based approach for Phase I could become inherently unstable. Ad Hoc is concerned, however, that the ILECs not receive excessive pricing flexibility that might diminish competition based upon negotiated or state-approved pricing for UNEs and other critical services that may not conform with a properly constituted TELRIC methodology.

jurisdiction to set pricing rules for UNEs, wholesale services, and local access and termination rates, the Commission's rules must require the ILEC to prove, as a threshold matter, that pricing levels for local exchange services comport with the pricing standards of the Act and the Commission's rules established in the *Interconnection Order*. Requiring the ILECs to match any geographic de-averaging that is permitted in interstate access with equivalent rate de-averaging for the parallel intrastate local exchange UNEs, etc., will discourage uneconomic choices based specifically upon jurisdictional classification. Such a requirement is not sufficient, however, to prevent the ILECs from shifting costs within or between relevant product or geographic markets in an anticompetitive manner. Thus, after this threshold showing, the ILECs should then be required to demonstrate the existence of actual competition in the relevant market that is sufficient to constrain the ILECs' market power.

2. Geographic Markets (¶¶ 168-210)

In the *Price Caps Second FNPRM*, the Commission tentatively described the relevant geographic market as needing to be "narrow enough to only encompass competing access services for the same set of customers, yet ... broad enough to be administratively workable."[96] The ILECs have persistently recommended microscopically small geographic areas (such as density zones, wire centers, or even Census Block Groups)

---

96 *Price Cap Second FNPRM* at ¶. 120.

as the relevant geographic market. None of these geographic areas is suitable.

The Commission itself has recognized that it would be administratively infeasible to use the wire center as the basis of the geographic market because there would be literally thousands of individual "markets." In addition, a wire-center based market definition would create countless opportunities for shifting shared and common costs from wire center serving areas in which entry has occurred or is imminently anticipated, to wire centers with minimal current or potential competitive activity.

Density zones raise similar problems associated with the sheer number of geographic units. Today, there are three density zones for special access and switched transport, with the highest traffic density designated as Zone 1. As a number of parties have pointed out to the Commission, the pricing zones for trunking have developed in a "checkerboard" fashion rather than in contiguous geographic areas.[97] Furthermore, as the Commission has previously noted, the amount of trunking traffic (which is the basis for determining existing "density" zones) may not be relevant to other functional market segments (e.g., the traffic-sensitive, common line, and interexchange baskets).[98] The Ad Hoc

---

97 *Id.* at ¶ 124.

98 *Id.*

Committee urges the Commission to avoid a chaotic and abuse-prone "balkanization" of ILEC service areas, and to resist piecemeal pricing flexibility that will create vast incentives and opportunities to shift the recovery of common costs from geographic markets that face competition to those that do not.

Instead, the Commission should define geographic markets that are sufficiently large to limit the ILEC's opportunity to shift costs in an anticompetitive manner. A LATA could serve as such a geographic market. The Ad Hoc Committee recognizes that the development of a relatively uniform level of competition across an entire LATA will take time, and that extensive geographic regions and functional market segments in which no consequential facilities-based competitive presence arises are likely to persist within most (if not all) LATAs for years to come. To meet the objective of protecting customers in the noncompetitive sub-regions of a LATA (*i.e.*, to prevent ILECs from shifting shared and common costs to such customers), while still allowing the ILEC to respond to competitive pressures that might exist for the majority of customers within the LATA, the Commission could require the ILEC to use a uniform rate structure within the LATA (which could include volume or term discounts or other rate differences based on cost variations within the LATA).[99] This requirement avoids dissecting the geographic market into unmanageable fragments,

while protecting customers in less competitive areas from subsidizing customers in more competitive areas. Consistent with the Commission's regulatory objectives, the requirement would extend to all customers in the LATA prices that reflect competitive marketplace forces. Requiring the ILECs to treat all customers within a LATA on an equivalent basis substantially reduces the opportunities for cost shifting and for surgically targeted strikes against new entrants with limited market presence. At the same time, the ILEC would be able to charge rates that reflect cost differences among customer groups or locations.

In order to implement such a solution, however, competitive conditions within a given LATA would have to exceed a certain threshold level. If this approach is implemented within a LATA in which competition is virtually nonexistent, the ILEC would respond by increasing prices throughout the area, sacrificing such competitive losses as might occur for the opportunity to exact supracompetitive prices for the largely monopolistic remainder of the LATA.

Moreover, the threshold must be defined multidimensionally. For example, an appropriate benchmark might be that at least X facilities-based local or access competitors are actively offering service in at least Y% of the exchanges within the LATA that are available to at least Z% of the customers therein. Checklists, such as that proposed at paragraph 163 of

---

[99] This approach was recommended by Time Warner in response to the Price Cap Second

the NPRM, are clearly necessary conditions for market-based pricing, but are not sufficient to assure that actual competition has developed to a point where prescriptive rate treatment can be eliminated.

While delay in the adoption of market-based pricing could theoretically cause ILECs to lose business that, had they been permitted to respond with market-based pricing, would have been retained, *premature elimination* of prescriptive pricing could prevent effective competition from developing at all. To the extent that the Commission may not be able to craft a policy in which the changeover occurs at the optimum moment, error favoring the development of competition is clearly to be preferred.

3. Treatment of embedded costs that exceed long-run incremental costs (¶¶ 247-270)

In the *Notice,* as well as in its recent *First Interconnection Order,* the Commission has supported ILEC rates set at forward-looking long run incremental cost. This outcome would be accomplished in the case of noncompetitive ILEC services, through an explicit rate prescription by the Commission. In the case of "competitive" services, the Commission assumes that market-based pricing by the ILECs and their competitors would approximate long run incremental cost.

The ILECs, however, contend that a requirement that they set prices at forward-looking incremental cost levels — whether imposed under the "prescriptive" approach or enforced by competitive marketplace forces

---

FNPRM. Time Warner Comments at 44-45.

under a "market-based" approach — would prevent them from recovering their previously-made capital investments.[100] Forward-looking costs are generally lower than the corresponding historic cost due to the effects of technological innovation, scale and other factors.[101]

Moreover, the ILECs assert that their existing stock of capital assets was acquired with the expectation that their regulated and protected monopoly status would continue. Thus, competitive entry and the resulting loss of market share will result in some of these assets becoming "stranded," in that they will no longer be capable of re-deployment for the purposes of serving other customers when the specific customer for whom they had been acquired elects to take service from a competing provider.[102]

The ILECs thus contend that they must be permitted to recover, in addition to the forward-looking costs that they will confront when furnishing services in the future, that portion of their historic "embedded" costs that they have previously committed and that exceeds the forward-looking cost

---

[100] Interconnection Appeal, Motion of Bell Atlantic, et al. for Expedited Consideration and for a Briefing Schedule, at 13-16 (filed September 6, 1996) ("Interconnection Appeal").

[101] Certain forward-looking costs may, however, actually be greater than historic embedded costs. For example, the costs associated with erecting supporting structures (poles and conduits) and for constructing buildings are clearly greater today than they were in the past. Further, the cost of placing outside plant cables, a heavily labor-intensive activity, is also likely to be greater on a forward-looking basis than the historic cost level.

[102] This can occur either because the plant involved is geographically tied to a specific customer location, or because a permanent drop in demand, due (for example) to a market share loss, will cause previously revenue-producing assets to become idle and non-revenue-producing.

level.[103] They claim that failure of the Commission to permit such recovery would constitute an unlawful taking of the ILECs' property in violation of the "takings clause" of the Fifth Amendment to the US Constitution.[104]

In all, the "gap" between historic embedded cost as reflected on the ILECs' books and the aggregate forward-looking incremental cost of ILEC services has been estimated as approximately $11 billion annually, reflecting some $7 billion in aggregate unrecoverable or "stranded" investment.[105]

a. Guaranteed recovery of embedded costs is contrary to the existing regulatory regime

The Commission can not simultaneously confer upon the ILECs the protections of rate of return regulation (*i.e.*, guaranteed recovery of embedded costs) and the pricing and earnings flexibility of non-regulated firms (*i.e.*, market-based pricing flexibility). Thus, the suggestion that the ILECs must be "made whole" for allegedly unrecoverable embedded costs cannot be squared with the regulatory paradigm under which they currently operate.

While the ILECs' argument might have had merit when these companies were regulated under traditional "rate of return regulation" ("RORR") and where the notion of "opening local markets to competition"

---

103 *Interconnection Appeal*, Motion of Bell Atlantic, et al. for Expedited Consideration and for a Briefing Schedule, at 13-16 (filed September 6, 1996).

104 *Id.*

was not even at the discussion stage, it cannot be squared with the current regulatory paradigm established by the Commission and, most recently, by the US Congress through its enactment of the 1996 Act.

Under the traditional regulatory model, a "social contract" was created between the utility and the public whereby the utility was granted an exclusive franchise to act as monopoly provider of the regulated service. With the franchise came the assurance of an opportunity to recover costs and to earn a fair return on the net book value of its used and useful investments incurred in the provision of regulated services, in exchange for which the utility agreed to limit its prices to those necessary to produce that "fair return."

Under RORR, an ILEC's booked investment and ongoing operating expenses establish its "revenue requirement," a level of revenues that is sufficient to permit recovery of depreciation accruals, reimbursement of out-of-pocket operating expenses, and produce a "fair return" on the net book value of the ILEC's investment (including associated income taxes). Although RORR does not necessarily guarantee full investment recovery and return, RORR contemplates that an ILEC will be given the opportunity to set its rates at a level sufficient to permit recovery of its revenue requirement, thus virtually eliminating any risk of loss or revenue erosion.

---

105 *NPRM* at ¶ 247.

In exchange for such guarantees of recovery and return, the ILEC accepts an upward constraint on its earnings at a maximum level that has been authorized for it by the regulatory authority, and is not permitted to set rates at levels that generate revenues so high that earnings in excess of that "fair return" will result. Under this "social contract" with the public (as administered by the regulatory agency), the ILEC thus foregoes opportunities for earnings enhancement in exchange for a nearly riskless earnings stream.

But rate of return regulation in its traditional form is no longer the prevailing regulatory paradigm:

- In 1990 the Commission made substantial modifications to that traditional RORR structure. Under the "price cap" rules for Tier 1 LECs, adopted in that year, ILEC rates were no longer specifically tied to ILEC costs, and ILECs were permitted to retain a portion of their earnings in excess of the "fair return" level.

- In 1995, the Commission modified its original price cap scheme such that ILECs willing to accept the highest in a range of "offset factors" are permitted to retain without limit any earnings in excess of the nominal "fair return" level.[106]

- The Commission has adopted several changes in the scope of ILEC services that are subject to economic regulation the effect of which is to provide ILECs with even more opportunities to utilize and exploit their network and organizational resources than existed under full-blown RORR. For example, certain so-called "enhanced" services are (in the federal jurisdiction) deregulated altogether, such that any earnings thereon do not enter into the price cap regulation process.

---

[106] The currently authorized rate of return for ILECs is 11.25%.

- The 1996 Act expressly prohibits state or federal regulatory agencies from relying exclusively on traditional RORR,[107] and expressly contemplates a general expansion of the scope of services and business activities in which BOCs may engage. For example, under the provisions of Section 271, BOCs will be permitted to enter the interLATA long distance market once certain conditions have been satisfied, offering additional earnings enhancement opportunities that fall outside of the scope of the formal price cap process.

Thus, if an ILEC is able, for example, to exploit its embedded base of telecommunications network resources so as to expand its markets and in so doing expand its revenues and profit levels, the Commission's current price cap rules would permit all such excess earnings to be retained without limit by the ILEC. It is not sufficient to look solely to the specific pricing and competitive policy initiatives that the ILECs portray as the source of their stranded investment problem. Rather, all of the various FCC and Congressional policy initiatives — price caps, local exchange competition, pricing flexibility, deregulation of certain services, the Commission's "wireline set-aside" guaranteeing valuable cellular licenses to wireline LECs,[108] and the new interLATA toll and other business opportunities that the 1996 Act creates, among others — collectively constitute the Commission's current and evolving method of regulation. While the ILECs may take issue with specific FCC actions they view as contrary to their economic interest, there have been a number of other Commission

---

[107] *See* 1996 Act, § 252(d)(1)(a) (pricing of interconnection and unbundled elements).

[108] *See* Cellular Communications Systems, *Order and Reconsideration*, 89 FCC 2d 59, 86-89 (1982); *see also* 47 CFR § 22.2; Rural Cellular Service Radio, 4 FCC Rcd 5272, 5274 (1988).

initiatives that have conferred substantial financial benefit upon the very same ILECs.

ILEC investors clearly do not believe that the current regulatory regime and possible changes to it imperil the ILECs' financial well-being. Expressing their confidence in the ILECs' abilities to fully recover their investments and earn a handsome return thereon, ILEC investors have demonstrated that they consider the total set of revenue-producing opportunities available to the ILEC in making their evaluation of ILEC shares. In fact, there is strong evidence to suggest that in evaluating ILEC stock investors do consider these other, non-current components of "return on investment":

- At the time of divestiture (1984), all of the RBHCs' shares were trading at approximately their net book value (i.e., the market-to-book ratio was approximately 1.0).

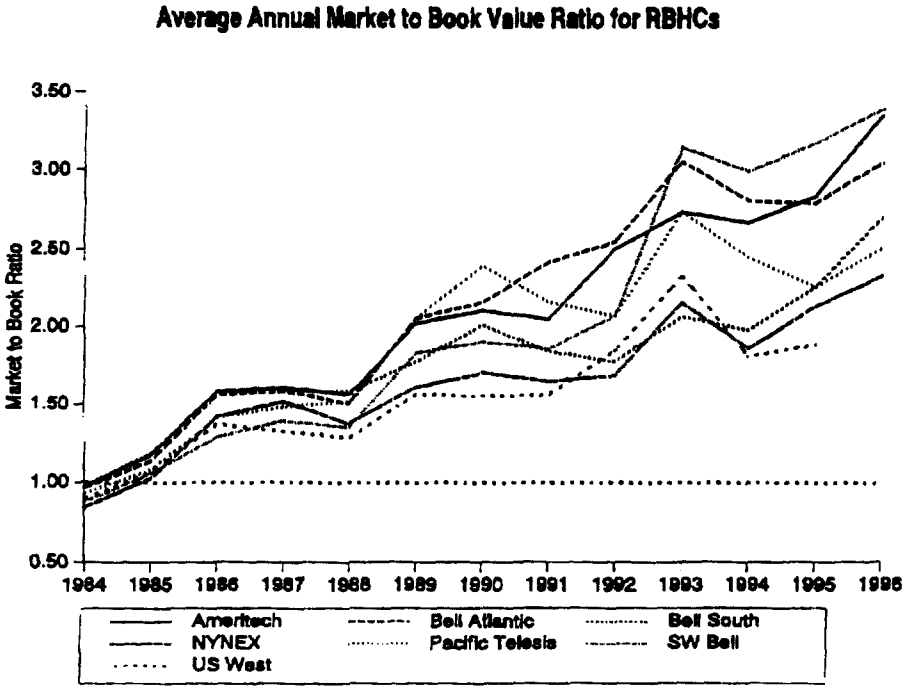
- As shown in Figure 1 on the following page, over the decade following divestiture, the market-to-book value ratios for all of the RBHCs grew steadily. In 1996, RBHC market-to-book value ratios when adjusted back to a regulated basis ranged from 2.33 to 3.40.[109]

- Although the absolute value of the market-to-book value ratio may be influenced by many factors, the persistent willingness of investors to pay considerable premiums for ILEC shares confirms the fact that investors do not perceive the cumulative and combined effect of FCC actions as so adversely impacting the ILECs' ability to earn a fair return on their investment as to constitute confiscation of the LECs' property.

---

[109] The Pacific Telesis market-to-book ratio is among the lowest of the seven BOCs, but this is most likely attributable to the 1994 spin-off of Air Touch. Even without cellular, Pacific Telesis' market to book ratio is well above 2, meaning that the expectations for a "pure play" ILEC is still more than adequate. If Telesis and Air Touch are aggregated, the combined ratio is even higher.

Figure 1



Source: Value Line Investors Survey, April 14, 1995, January 10, 1997.

Investors do — and the Commission should — value an ILEC's assets in the aggregate, as a "going concern," and not on the piecemeal basis that underlies the "stranded investment" calculations. From this more comprehensive vantage point, it is clear that the additional revenue- and earnings-generating opportunities that the overall regulatory program afford the ILECs easily overcomes any nominal erosion in the value of particular assets viewed in isolation. This point is further corroborated by the decision by SBC to pay $16.5 billion in SBC stock to acquire Pacific Telesis, an amount that is some $3.77 billion above the "book value" of Pacific Telesis' principal assets — Pacific Bell and Nevada Bell. Actions by ILEC investors and by the ILECs themselves belie cries of poverty.

b. ILECs face no confiscation of revenues due to "competition" or regulatory initiatives proposed in this docket.

The sheer lack of competition for most ILEC services makes it possible, in the context of price cap regulation, for the ILECs to set prices in excess of those that would be permitted under RORR and to sustain these prices in the marketplace as an economic matter. That price levels well in excess of those that would exist under RORR are sustainable in the marketplace is sufficient by itself to demonstrate how fundamentally

insufficient the existing level of competition is in effectively constraining ILEC prices to "competitive levels."[110]

In enacting the 1996 Act, Congress was clearly aware of these conditions. The Act expresses a national commitment to achieving a competitive telecommuni-cations marketplace, but at the same time recognizes that this cannot happen without affirmative regulatory intervention. Without effective competition in any particular market segment, the ILECs can easily impose charges that exceed long run incremental cost. And by maintaining policies and practices, including pricing rules, that discourage entry, the incumbent LECs can insulate themselves from competition unless, through regulatory requirements, they must cooperate to facilitate entry.

One of the specific ways by which the 1996 Act seeks to reduce entry barriers and the distortions resulting from sunk costs is to mandate that ILECs provide, on an unbundled basis, access to most elements of their infrastructure. Moreover, ILECs are required to offer most of their services to non-facilities-based resellers at wholesale rates, permitting competition to occur at the retail level without imposing burdensome investment requirements on the new entrant. At the same time, the ILEC can continue to derive revenues from its embedded network both through

[110] It would not be sufficient for the regulatory authorities merely to authorize prices in excess of long run incremental cost as a means of recovering stranded investment; those prices would

resale of total services and through the sale of unbundled network elements ("UNEs").

But ILECs — and BOCs in particular — get substantial benefits as well under the new competitive paradigm. The Act requires regulators at both the state and federal levels to adopt regulatory mechanisms that do not rely exclusively upon rate of return type regulation. These mechanisms enable the ILECs to increase their overall earnings above traditional regulatory levels through initiatives such as cost-cutting, market expansion and, in some cases, simply by raising prices. BOCs, in addition, will be allowed to enter the interexchange services (long distance) market upon satisfaction of certain specific requirements, thus developing new lines of business and profit opportunities.

Even before the enactment of the 1996 Act, the Commission was well on its way to introducing regulatory devices that would significantly expand the ILECs' earnings opportunities, and permit them to earn profits well in excess of those permitted under rate of return regulation. Specifically, in its LEC price caps decision and the subsequent *First Report and Order* in CC Docket 94-1, the Commission established "price cap" regulation under which ILECs are permitted to set rates which not only permit full recovery of their embedded investment, but also produce earnings well in excess of the nominal "authorized rate of return." Six of the

---

have to be sustainable as an economic matter. And the reason that they are sustainable as an

seven RBOCs have elected a price cap option under which they may retain 100% of their earnings in excess of the nominal 11.25% authorized level, without any obligation to refund, cap, or share any excess earnings with ratepayers.[111]

c. The ILECs made the majority of current book investment subject to the risk allocations of incentive regulation

The bulk of the ILECs' alleged stranded investment should not be entitled automatically to full recovery. In a study undertaken by Economics and Technology, Inc. (ETI) and submitted by AT&T in CC Docket 96-98 in May, 1996,[112] ETI found that fully 60% of all ILEC net investment on the books as of the end of 1995 had been acquired since the beginning of 1990, the year in which the FCC adopted price cap regulation for the local carriers. Moreover, a reasonably prudent ILEC would have been aware that the acquisition costs of capital assets were decreasing rapidly and that competition in all segments of the telecommunications industry was on the horizon, perhaps even as early as immediately following the break-up of the former Bell System. ILECs and their experts have been warning this Commission and others of the imminent explosion of competition since the

---

economic matter is because entry into ILEC local exchange markets is extremely difficult.

[111] Telecommunications Reports, April 8, 1996, at 13.

[112] Analysis of Incumbent LEC Embedded Investments: An Empiracal Perspective on the "Gap" Between Historic Costs and Forward-Looking TSLRIC, filed as part of AT&T's Reply Comments in 96-98, May 30, 1996.

late 1980s.[113] Moreover, while ILECs frequently complained of allegedly insufficient depreciation rates, their capital acquisitions were nonetheless made with full knowledge of the then-prescribed rates and lives. Thus, since the beginning of 1990, and perhaps well before that date, ILEC capital investments were being made "with both eyes open," under a regulatory system that did not perpetuate the guaranteed recovery of RORR.

Some of these outlays were unarguably made to accommodate growth in demand for basic services. However, others may have been made for strategic or competitive reasons, for example, to provide enhanced functionalities to support vertical and competitive services and features; to deploy broadband feeder and distribution facilities in anticipation of the ILEC's ultimate entry into the video market; to expand "official services" in in-region interLATA networks in anticipation of ultimate entry into the interLATA services market; or to generally expand and enhance overall network capacity, with the effect of making entry more difficult for start-up firms lacking ubiquitous connectivity.

In many cases — particularly where the acquisition of digital switching and transmission plant was involved — price levels were rapidly decreasing, such that premature accumulation of excess capacity was virtually guaranteed to create "stranded" investment due not to competitive entry or market share loss, but simply to the declining values of individual

---

[113] *See e.g.,* NYPSC 28710 *Order Instituting Bypass Investigation*, December 27, 1983 and